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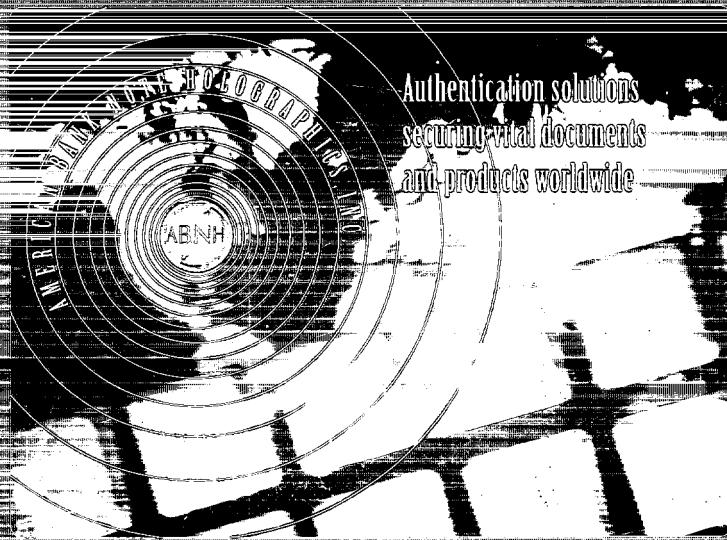
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American  
Bank Note

Holographics, Inc.



Authentication solutions  
securing vital documents  
and products worldwide

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2003 Annual Report

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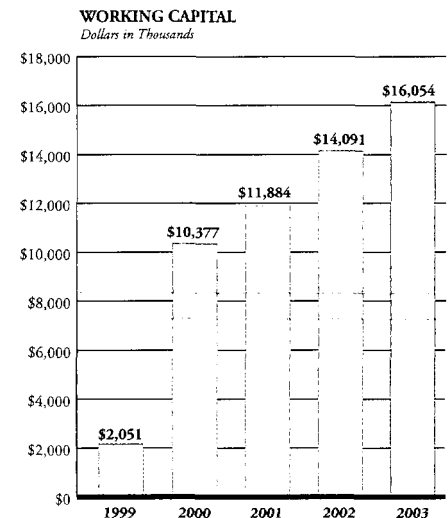
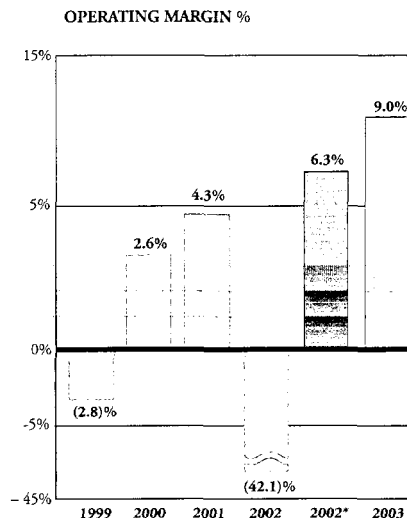
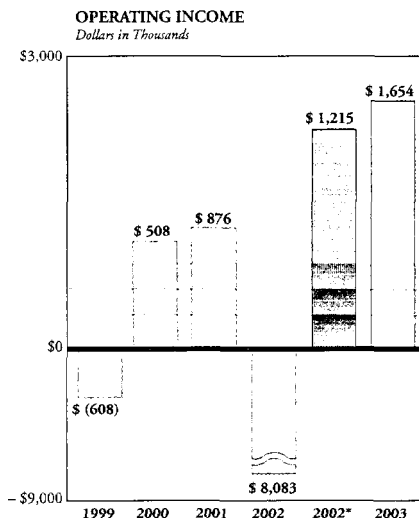
# Company Profile

American Bank Note Holographics, Inc. ("ABNH") is a world leader in the design, production and marketing of security holograms that authenticate valuable documents and products. ABNH security devices are used to protect a wide range of products and documents including most major transaction cards, secure documents issued by the United States and other governments, pharmaceuticals and other valuable consumer products.

The need for better security for documents and products has escalated as new technologies have made it easier for criminals and terrorists to counterfeit a wide variety of products and documents of value. The security devices that ABNH designs and produces address this growing threat and provide an effective deterrent to counterfeiting since they are extremely difficult to copy and easily recognizable. ABNH combines its world-class holographic origination capabilities with proprietary applications to create effective solutions to combat the increasing worldwide problems of counterfeiting, tampering, diversion and fraud.

ABNH maintains its corporate headquarters in Elmsford, New York, and production facilities in Elmsford, Huntingdon Valley, Pennsylvania and Dalton, Massachusetts. Additional information may be obtained at [www.abnh.com](http://www.abnh.com).

## Financial Highlights



\* Pro Forma 2002 operating income and operating margin percentage excludes the non-cash impairment charges to goodwill and fixed assets of \$9,298, which were included in operating expenses in 2002. Management believes that operating income and operating margin percentage excluding the non-cash impairment charges provide a clearer picture of the Company's operational performance and comparison to other periods.

We are proud to report that 2003 was a year of both record financial performance and significant commercial achievement. We have significantly strengthened ABNH's position in many ways, and remain committed to supporting the global objective of enhanced security for critical documents and products.

In 2003, ABNH reported its highest profits since becoming a public company. We have streamlined operations and refocused our product mix, enabling us to improve margins and prepare for future growth. In 2003, we successfully offset a temporary decline in sales to MasterCard International and the elimination of some other older accounts, with new customers in the transaction card, identification card and pharmaceutical markets. While overall sales were down 2% in 2003, we have significantly improved profits. We have continued to strengthen our financial position, which enables us to invest in improving our capabilities to capitalize on attractive growth opportunities.

We signed two important deals with MasterCard in 2003. In February, we signed a new contract which strengthened the relationship, and extended the supply agreement to 2008. In September, we signed an amendment to the contract which provided for the supply of the new MasterCard Debit hologram, and extended the supply agreement to at least 2011. MasterCard received court approval to differentiate its United States issued credit and debit cards with the two different holograms in connection with its settlement of a major class action litigation. We believe this marks the beginning of a new era in the role of

the hologram, as consumers and merchants are encouraged to examine the hologram more closely now since it is the only required mark distinguishing the credit and debit products. This additional function of product identification enhances the value of the hologram on the card and reinforces its traditional objectives as a unique authenticator and attractive branding device.

We also expanded our relationship with Visa and other transaction card issuers in 2003. We designed and began selling a new hologram for the Visa Key card this year, and we have been working closely with Visa on other innovative programs. We have also been working with other major card issuers and manufacturers on new programs to reinforce our position as the leading supplier of secure optical devices to the transaction card market.

We enhanced our position in the identification card market in 2003, as this market has become increasingly sensitive to the need for enhanced security. We initiated several new projects for secure identification documents with agencies of the United States government and foreign governments in 2003. Our patented demetallized holographic laminate offers significant advantages for secure ID's since it provides a higher level of counterfeit protection while simultaneously protecting the document from alteration or substitution. We intend to invest in this product line as we anticipate increased demand for secure identification documents.

We are also pleased with our increasing role in providing security for pharmaceutical products. We applaud the FDA's recent efforts in highlighting the urgent need to combat the problem of counterfeit drugs. Our products have already become an important component of the anti-counterfeiting and tampering strategies of major pharmaceutical companies and we intend to work even more closely with pharmaceutical companies and their packaging suppliers in meeting their security and packaging objectives.

The need for better security solutions to protect documents and products is continuing to escalate. Improved imaging and copying technologies have become widely available to the professional and casual counterfeiter. But more urgently, counterfeiting and tampering are tools for terrorists to fund their illicit activities and threaten both the public's safety and consumer confidence. Governments and corporations that produce financial, identification and consumer products must be proactive in protecting these products from terrorist and criminal attack.

We remain committed to investing in developing comprehensive solutions to protect important documents and products, and serving our customers' objectives of combating the escalating problems of counterfeiting and fraud. We are proud of the role ABNH is serving in helping to protect the security of the documents and products that are essential to a free and productive society.



We are grateful for the continued support of our shareholders, employees, customers and partners, and we look forward to a prosperous and secure future.

Kenneth H. Traub  
President and Chief Executive Officer

Salvatore F. D'Amato  
Chairman of the Board

(In Thousands, Except Per Share Data)	YEARS ENDED DECEMBER 31,				
	2003	2002	2001	2000(c)	1999
<b>STATEMENT OF INCOME DATA:</b>					
Revenue:					
Sales (a)	\$ 18,284	\$ 18,665	\$ 20,016	\$ 19,029	\$ 21,194
Royalty income	48	555	466	444	535
	18,332	19,220	20,482	19,473	21,729
Costs and expenses:					
Cost of goods sold	8,279	8,926	9,962	8,876	11,247
Selling and administrative (a) (b)	6,518	7,136	7,314	8,085	9,803
Research and development	1,142	1,143	1,233	928	261
Depreciation and amortization	739	800	1,097	1,076	1,026
Impairment of goodwill and fixed assets (d)	—	9,298	—	—	—
	16,678	27,303	19,606	18,965	22,337
Operating income (loss)	1,654	(8,083)	876	508	(608)
Other income (expense):					
Other income	—	—	—	—	24
Interest, net	97	113	258	(512)	(985)
Settlement with Former Parent	—	—	—	519	—
Settlement of shareholder litigation	—	—	—	(3,508)	—
Patent settlement and other	—	691	—	—	—
	97	804	258	(3,501)	(961)
Income (loss) before provision for (benefit from) income taxes	1,751	(7,279)	1,134	(2,993)	(1,569)
Provision for (benefit from) income taxes	744	858	543	(1,110)	(494)
Net income (loss)	\$ 1,007	\$ (8,137)	\$ 591	\$ (1,883)	\$ (1,075)
Net income (loss) per share:					
Basic and diluted	\$ 0.05	\$ (0.44)	\$ 0.03	\$ (0.12)	\$ (0.08)
Weighted average shares outstanding:					
Basic	18,484	18,484	18,484	15,421	13,636
Diluted	18,526	18,484	18,484	15,421	13,636

	DECEMBER 31,				
	2003	2002	2001	2000(c)	1999
<b>BALANCE SHEET DATA:</b>					
Working capital	\$ 16,054	\$ 14,091	\$ 11,884	\$ 10,377	\$ 2,051
Total assets	21,020	20,130	28,586	29,134	22,425
Total debt	—	—	—	—	1,268
Total stockholders' equity	17,449	16,442	24,579	23,988	13,455

(a) Sales have been adjusted from 1999 through 2000 to reflect the reclassification of shipping charges billed to customers, which were previously netted in selling and administrative expenses.

(b) During the year ended December 31, 1999, we incurred costs of \$3.5 million, net of \$0.6 million of insurance reimbursements, in connection with the audit committee investigation and related restatement efforts and defense of litigation. Also, during 1999, we determined that we would not establish our own post-retirement health care plan and reversed a \$404,000 accrued liability in this regard. The costs and reversal are included in selling and administrative expenses.

(c) During the year ended December 31, 2000, we incurred costs of \$3.4 million regarding the settlement of the shareholder litigation, and \$0.1 million in connection with fines and costs incurred regarding the SEC and U.S. Attorney investigations. In addition, we reversed \$0.5 million from accounts payable and accrued expenses resulting from a settlement, which we entered into with our Former Parent. These costs are included in other income (expense) on the accompanying statement of operations. Additionally in the third quarter of 2000, our insurance carriers agreed to pay us \$750,000 as a product liability reimbursement, which we included in cost of sales.

(d) As a result of our annual test for impairment of goodwill, we recorded an impairment charge of \$7.4 million during the quarter ended December 31, 2002 (see Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1 of the Notes to the Financial Statements). As a result of our review of long-lived assets for impairment during the quarter ended December 31, 2002, we recorded an impairment charge of \$1.9 million (see Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1 of the Notes to the Financial Statements).

# Management's Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion and analysis should be read in conjunction with "Selected Financial Data" and our financial statements, including the notes thereto, appearing elsewhere in this report.*

## Overview

American Bank Note Holographics, Inc. ("ABNH") was, until July 20, 1998, a wholly-owned subsidiary of American Banknote Corporation ("ABN" or the "Former Parent"). On that date, ABN completed the sale of 13,636,000 shares of our common stock in an initial public offering (the "Offering"), representing ABN's entire investment in ABNH. We did not receive any proceeds from the Offering.

ABNH originates, mass-produces and markets holograms. Our holograms are used primarily for security applications such as counterfeiting protection for credit and other transaction cards, identification cards and documents of value, as well as for tamper resistance and authentication of high-value consumer and industrial products. We also produce non-secure holograms for packaging and promotional applications. Our sales of holograms for security applications generally carry higher gross margins than sales for non-security applications.

Concerns regarding counterfeiting, piracy and other infractions that can result in lost sales, lost goodwill and product liability claims drive the use of product authentication holograms. Companies in various industries have utilized holograms as authentication devices to reduce potential losses. Also, concerns over counterfeiting and copying have prompted the use of holograms on documents of value, including currency, passports, gift certificates, vouchers, stamps, tickets and other financial instruments.

A significant portion of our business is derived from orders placed by credit card companies, including MasterCard and manufacturers of VISA brand credit cards and variations in the timing of such orders can cause significant fluctuations in our sales. Sales to MasterCard for the years ended December 31, 2003, 2002 and 2001 were approximately 33%, 41%, and 37%, respectively. We entered into an agreement with MasterCard dated February 28, 2003, which replaced the agreement dated February 1, 1996, as amended. We entered into an amendment to this agreement on September 29, 2003, in which MasterCard retained us to produce a new hologram for the Debit MasterCard and extended the agreement to February 2011, subject to automatic renewal if not terminated by either party. The new agreement provides that MasterCard will receive three sequential price reductions of approximately 3% each, effective at the beginning of 2003, 2004 and 2006. We are currently the exclusive supplier to MasterCard. Sales to VISA card manufacturers were approximately 30%, 26%, and 23%, respectively, of sales for the years ended December 31, 2003, 2002 and 2001. We do not have long-term purchase contracts with VISA and we supply holograms to approximately 50 VISA authorized card manufacturers pursuant to purchase orders. Currently we are one of two companies authorized to manufacture and sell VISA brand holograms to manufacturers of VISA brand credit cards. If either MasterCard or VISA were to terminate its respective relationship with us or substantially reduce their orders, there would be a material adverse effect on our business, financial condition, results of operations and cash flows.

Holograms are sold under purchase orders and contracts with customers. Sales and the related cost of goods sold are generally recognized at the latter of the time of shipment or when title passes to customers. In some

situations, we have shipped product where the sale is contingent upon the customers' use of the product. In these situations, we do not recognize sales upon product shipment, but rather when the buyer of the product informs us that the product has been used. Additionally, pursuant to terms with a certain customer, completed items are stored on behalf of the customer at our on-site secured facility and, in that instance, sales are recognized when all of the following have occurred: the customer has ordered the goods, the manufacturing process is complete, the goods have been transferred to the on-site secured facility and are ready for shipment, the risk of ownership has passed to the customer and the customer has been billed for the order. At December 31, 2003 and 2002, accounts receivable from this customer totaled \$1.0 million and \$1.6 million, respectively.

We purchase certain key materials used in the manufacture of our holograms and outsource certain key processes from third party suppliers, some of which are sole source relationships, with whom we do not have supply contracts. Any problems that occur with respect to the delivery, quality or cost of any such materials or processes could have a material adverse effect on our financial position, results of operations and cash flows.

During 2003, 2002 and 2001, export sales accounted for approximately 28%, 27% and 28%, respectively, of total sales. All of our export sales are presently denominated in U.S. dollars.

Sales may fluctuate from quarter to quarter due to changes in customers' ordering patterns. Customers do not typically provide us with precise forecasts of future order quantities. Quarterly demand for holograms may be materially influenced by customers' promotions, inventory replenishment, card expiration patterns, delivery schedules and other factors which may be difficult for us to anticipate.

Cost of goods sold includes raw materials such as nickel, foils, films and adhesives; labor costs; manufacturing overhead; and hologram origination costs (which represent costs of a unique master hologram that is made to customer specifications and is an integral part of the production process). As a result, costs of goods sold are affected by product mix, manufacturing yields, costs of hologram originations and changes in the cost of raw materials and labor.

Selling and administrative expenses primarily consist of salaries, benefits and commissions for our corporate, sales, marketing and administrative personnel, marketing and promotion expenses, legal and accounting expenses and expenses associated with being a public company.

In accordance with a tax allocation agreement in effect through the date of the Offering, we were included in the consolidated Federal income tax return and, in certain instances, consolidated or combined state and local income tax returns of ABN and made payments to ABN based on the amounts which would be payable as Federal, state and local income taxes as if consolidated or combined returns were not filed. We computed our federal, state and local income tax provision as if we were filing separate income tax returns, without regard to the tax allocation agreement. During 2000, we reached an agreement with ABN which provided, among other things, for ABN to be responsible for and pay all of our asserted and unasserted income, franchise and similar tax liabilities for the period January 1, 1990 through July 20, 1998 and indemnify us with respect to any such liabilities. For periods subsequent to the date of the Offering, we have been filing our own federal and state income tax returns.

### Critical Accounting Policies

We make use of estimates and assumptions that impact the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to bad debts, inventories and intangible assets. These estimates and assumptions are based on historical results and trends as well as our forecasts as to how these might change in the future.

We believe the following critical accounting policies, among others, impact the significant judgments and estimates we use in the preparation of our financial statements:

#### Revenue Recognition

We recognize revenue in accordance with the provisions of the Securities and Exchange Commission's ("SEC") Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition." Specifically, sales and the related cost of goods sold are generally recognized at the latter of the time of shipment or when title passes to customers. In some situations, we have shipped product where the sale is contingent upon the customers' use of the product. In these situations, we do not recognize sales upon product shipment, but rather when the buyer of the product informs us that the product has been used. Additionally, pursuant to terms with a certain customer, completed items are stored on behalf of the customer at our on-site secured facility and, in that instance, sales are recognized when all of the following have occurred: the customer has ordered the goods, the manufacturing process is complete, the goods have been transferred to the on-site secured facility and are ready for shipment, the risk of ownership has passed to the customer and the customer has been billed for the order.

#### Allowance for Doubtful Accounts

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make the required payments. We recognize allowance for doubtful accounts based on the length of time the receivables are past due, the current business environment and our historical experience. If the financial condition of our customers were to deteriorate or if economic conditions were to worsen, additional allowances may be required in the future.

#### Inventory Valuation

Inventories are stated at the lower of cost or market with cost being determined on the first-in, first-out (FIFO) method. At each balance sheet date, we evaluate our ending inventory for excess quantities and obsolescence. We provide reserves for estimated obsolescence equal to the difference between the cost of the inventory and its estimated market value. We fully reserve for inventories deemed obsolete. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required.

#### Impairment of Goodwill and Long-Lived Assets

We account for goodwill and long-lived assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142") and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 142, which provides that goodwill should not be amortized but instead tested for impairment on an annual basis, was adopted by us on January 1, 2002. The impairment testing is performed in two steps: (i) the determination of impairment, based on our fair value compared with our carrying value, and (ii) if there is an indication of impairment, this step measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. In accordance with SFAS No. 142, we completed the transitional impairment test during the quarter ended March 31, 2002, which testing indicated that no adjustment was

required upon the adoption of the pronouncement. We performed the annual test for impairment required by SFAS No. 142 during the quarter ended December 31, 2002. At that time, our fair value (based on quoted market prices) was found to be less than our carrying amount, and accordingly, we recorded a \$7.4 million impairment charge for the year ended December 31, 2002. This charge represents the full impairment of the goodwill on our balance sheet. SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. During the quarter ended December 31, 2002, we recorded a charge for the impairment of long-lived assets of \$1.9 million to write off fixed assets consisting of master plates which will no longer be used. This charge represents the full impairment of this long-lived asset on our balance sheet. The goodwill and the long-lived assets arose through purchase accounting by our Former Parent, as it related to us, in connection with our Former Parent's 1990 merger.

### Results of Operations

#### Comparison of the Year Ended December 31, 2003 to the Year Ended December 31, 2002

**Sales.** Sales decreased by \$0.4 million, or 2.0%, from \$18.7 million in 2002 to \$18.3 million in 2003. The decrease was due to a decrease in sales to MasterCard of the original MasterCard hologram of \$2.4 million and a discontinuation of the Europay hologram of \$0.4 million which was partially offset by sales of \$0.8 million of the new Debit MasterCard hologram, an increase in sales of identification products of \$0.8 million and a net increase in sales of other products of \$0.8 million.

**Royalty Income.** Royalty income for the year ended December 31, 2003 decreased \$0.5 million from the year ended December 31, 2002 due to the expiration of a patent license agreement.

**Cost of Goods Sold.** Cost of goods sold decreased by \$0.6 million, or 7.3%, from \$8.9 million in 2002 to \$8.3 million in 2003. As a percentage of sales, cost of goods sold decreased from 47.8% in 2002 to 45.3% in 2003. The decrease in cost of goods sold as a percentage of sales of 3% was primarily due to decreases in provisions for warranty, obsolescence and royalties of 3% and lower production costs of 2% offset by a 2002 vendor reimbursement of 2% which did not recur in 2003.

**Selling and Administrative Expenses.** Selling and administrative expenses decreased by \$0.6 million, from \$7.1 million in 2002 to \$6.5 million in 2003. As a percentage of sales, selling and administrative expenses decreased from 38.2% in 2002 to 35.6% in 2003. The decrease in selling and administrative expenses is primarily due to a decrease in other selling and administrative expenses of \$0.5 million primarily due to decreases in expenses for insurance, telephone, travel, show, sales samples and bad debt expenses and a decrease in salaries and benefits of \$0.1 million primarily due to lower headcount and commissions.

**Research and Development.** Research and development expenses remained relatively unchanged.

**Impairment of Goodwill and Fixed Assets.** The 2002 impairment charges of \$7.4 million, to write off goodwill recorded under the requirements of SFAS No. 142, and \$1.9 million, to write off fixed assets recorded under the requirements of SFAS No. 144, did not recur in 2003.

**Other Income.** Other income decreased \$0.7 million from \$0.8 million in 2002 to \$0.1 million in 2003. The decrease was primarily due to income from settlement agreements in 2002 that did not recur in 2003.

**Income Taxes.** Income tax expense decreased \$0.1 million from \$0.9 million in 2002 to \$0.8 million in 2003. The decrease was primarily due to a decrease in taxable income in 2003 after giving effect to impairments of goodwill and fixed assets which are permanent differences for tax purposes.

#### **Comparison of the Year Ended December 31, 2002 to the Year Ended December 31, 2001**

**Sales.** Sales decreased by \$1.3 million, or 6.7%, from \$20.0 million in 2001 to \$18.7 million in 2002. The decrease in sales was due primarily to a decrease in sales of non-credit card security holograms due to the conclusion of certain lower margin programs in 2001.

**Royalty Income.** Royalty income increased \$0.1 million or 19.1%, from \$0.5 million in 2001 to \$0.6 million in 2002. The increase was due to higher reported licensee revenue in 2002.

**Cost of Goods Sold.** Cost of goods sold decreased by \$1.1 million, or 10.4%, from \$10.0 million in 2001 to \$8.9 million in 2002. As a percentage of sales, cost of goods sold decreased from 49.8% in 2001 to 47.8% in 2002. The decrease was comprised of a decrease in production costs of 3% primarily resulting from the effect of cost reductions put in place during 2002 and the elimination of some lower margin sales, and a decrease of 2% resulting from the settlement of a vendor dispute offset by an increase in the provision for inventory obsolescence of 1%, an increase in warranty expense of 1% and an increase in royalty expense of 1% related to a settlement of a patent license matter.

**Selling and Administrative Expenses.** Selling and administrative expenses decreased by \$0.2 million, from \$7.3 million in 2001 to \$7.1 million in 2002. As a percentage of sales, selling and administrative expenses increased from 36.5% in 2001 to 38.2% in 2002. The decrease in expenses is primarily due to a decrease in selling salaries and benefits of \$0.2 million primarily resulting from a decrease in personnel and a decrease in other selling expenses of \$0.2 million primarily related to reductions in travel and show expenses offset by increases in other administration expenses of \$0.1 million related to increases in general insurance and relocation expenses and an increase in bad debt expense of \$0.1 million due to an increase in the allowance for doubtful accounts due to an increase in the aging of accounts receivable.

**Research and Development.** Research and development expenses decreased \$0.1 million from \$1.2 million in 2001 to \$1.1 million in 2002. As a percentage of sales, research and development expenses decreased from 6.2% in 2001 to 6.1% in 2002. The decrease is primarily due to a decrease in research and development testing expense in 2002.

**Impairment of Goodwill and Fixed Assets.** We performed our annual impairment test of goodwill under SFAS No. 142, during the quarter ended December 31, 2002. Upon completion of the test we determined that goodwill had been impaired as a result of a decrease in our market capitalization. Accordingly, we recorded an impairment charge of \$7.4 million during the quarter ended December 31, 2002, reflecting the write-down of the carrying value of goodwill. In addition, during the quarter ended December 31, 2002, we recorded an asset impairment

charge of \$1.9 million to write off fixed assets consisting of master plates which will no longer be used. This impairment was recorded under the requirements of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

**Other Income (Expense).** Other income (expense) increased by \$0.5 million from \$0.3 million in 2001 to \$0.8 million in 2002. This increase was due to a patent settlement agreement entered into in the third quarter of 2002 for \$0.6 million and the settlement of a dispute with a former agent of ours in the fourth quarter of 2002 for \$0.1 million offset by a decrease in interest income of \$0.2 million resulting from lower interest rates in effect during 2002.

**Income Taxes.** Income tax expense increased \$0.3 million or 58% from \$0.6 million in 2001 to \$0.9 million in 2002. The increase was primarily due to an increase in taxable income in 2002 after giving effect to the impairment of goodwill and fixed assets which are permanent differences for tax purposes.

#### **Seasonality**

Our sales have not generally exhibited substantial seasonality. However, our sales and operating results to date have, and future sales and therefore operating results may, continue to fluctuate from quarter to quarter. The degree of fluctuation will depend on a number of factors, including the timing and level of sales, any change in the pricing of our products and the mix of products sold. Because a significant portion of our business is expected to be derived from orders placed by a limited number of large customers, variations in the timing of such orders could cause significant fluctuations in our operating results. Customers do not typically provide us with precise forecasts of future order quantities. Quarterly demand for holograms may be materially influenced by customers' promotions, inventory replenishment, card expiration patterns, delivery schedules and other factors which may be difficult for us to anticipate. Other factors that may result in fluctuations in operating results include the timing of new product announcements and the introduction of new products and new technologies by us or our competitors, delays in research and development of new products, increased research and development expenses, availability and cost of materials from our suppliers, competitive pricing pressures and financing costs.

#### **Liquidity and Capital Resources**

At December 31, 2003, we had \$11.3 million of cash and cash equivalents and working capital of \$16.1 million.

On June 30, 2000, we entered into a Stock Purchase Agreement (the "Agreement") with Crane & Co., Inc. ("Crane"). Under the Agreement, we sold 3,387,720 shares of our common stock to Crane for an aggregate purchase price of \$9,316,230. The Agreement also provides that our Board of Directors and the audit committee of our board of directors each be expanded by one position, which was filled by Douglas A. Crane, a representative of Crane. The Agreement also provides that, for as long as Crane owns at least 51% of the shares of common stock purchased under the Agreement, Crane shall be entitled to designate one director on the management slate of nominees to our board of directors, and that, should our board of directors be expanded to a number greater than six, then our board of directors shall be expanded by another seat, and Crane shall be entitled to nominate an additional director.

The Agreement also contains a standstill provision, whereby Crane agreed, that, among other things, neither it nor its affiliates, except as otherwise provided for in the Agreement, will acquire more than its current proportionate share of our outstanding securities. The standstill provision also provides that Crane will not offer, sell or transfer any of its voting securities of ABNH during a tender or exchange offer if such

offer is opposed by our board of directors. In connection with the transaction, Crane also received the right to cause us to register Crane's shares for public resale and the right to include such shares in any future registration of our securities, subject to certain exceptions.

Net cash provided by operating activities was \$3.1 million for the year ended December 31, 2003, as compared to \$1.6 million of cash provided by operating activities for the prior year. For the year ended December 31, 2003, our net income adjusted for non-cash charges provided cash of \$2.5 million compared to \$3.0 million of cash provided by our net loss adjusted for non-cash charges in the prior year. For the year ended December 31, 2003, cash provided by changes in operating assets and liabilities was \$0.6 million compared to cash used for changes in operating assets and liabilities of \$1.4 million in the prior year.

Investing activities for the years ended December 31, 2003 and 2002 used cash flows of approximately \$0.5 million and \$0.4 million, respectively. These activities primarily reflected capital expenditures for the respective years. We anticipate that capital expenditures in 2004 and

2005 will be approximately \$0.5 million for each year. These amounts relating to capital expenditures are intended to improve production capabilities, expand our product line and reduce future operating costs.

There were no financing activities for the years ended December 31, 2003 and 2002.

We believe that cash flows from operations and our cash balances will be sufficient to meet working capital needs, and fund capital expenditures for the next twelve months.

On March 17, 2003, our board of directors authorized the repurchase of up to \$2.0 million of our outstanding common stock. Under the terms of the repurchase plan, we were authorized to make purchases from time-to-time, either on the open market or through privately negotiated transactions as conditions warrant, over a period of twelve months. The stock repurchase plan was terminated on December 15, 2003 without any shares being repurchased under the plan.

The following table quantifies our future obligations, which consist primarily of lease obligations (in thousands):

	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Lease obligations	\$ 3,666	\$ 1,006	\$ 1,824	\$ 836	\$ —

### Impact of Inflation

In recent years, inflation has not had a significant impact on our historical operations. There can be no assurance that inflation will not adversely

affect our operations in the future, particularly in emerging markets where inflationary conditions tend to be more prevalent.

# Balance Sheets

(In Thousands, Except Share Data)	DECEMBER 31,	
	2003	2002
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 11,341	\$ 8,659
Accounts receivable, net of allowance for doubtful accounts of \$180 and \$210	3,174	3,661
Inventories	2,386	2,541
Deferred income taxes	981	1,347
Prepaid expenses	385	396
Other	150	345
<b>Total current assets</b>	<b>18,417</b>	<b>16,949</b>
MACHINERY, EQUIPMENT AND LEASEHOLD IMPROVEMENTS—Net of accumulated depreciation and amortization of \$9,238 and \$8,505		
	2,490	2,782
OTHER ASSETS	113	399
<b>TOTAL ASSETS</b>	<b>\$ 21,020</b>	<b>\$ 20,130</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
CURRENT LIABILITIES:		
Accounts payable	\$ 687	\$ 966
Accrued expenses	1,627	1,803
Customer advances	49	89
<b>Total current liabilities</b>	<b>2,363</b>	<b>2,858</b>
DEFERRED INCOME TAXES	1,208	830
<b>Total liabilities</b>	<b>3,571</b>	<b>3,688</b>
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred Stock, authorized, 5,000,000 shares; no shares issued or outstanding	—	—
Common Stock, par value \$0.01 per share, authorized, 40,000,000 shares; issued and outstanding, 18,483,720 shares	185	185
Additional paid-in capital	23,994	23,994
Accumulated deficit	(6,730)	(7,737)
<b>Total stockholders' equity</b>	<b>17,449</b>	<b>16,442</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 21,020</b>	<b>\$ 20,130</b>

*The accompanying notes are an integral part of these financial statements.*

# Statements of Operations

(In Thousands, Except Per Share Data)	YEARS ENDED DECEMBER 31,		
	2003	2002	2001
REVENUE:			
Sales	\$ 18,284	\$ 18,665	\$ 20,016
Royalty income	48	555	466
<b>Total revenue</b>	<b>18,332</b>	<b>19,220</b>	<b>20,482</b>
COSTS AND EXPENSES:			
Cost of goods sold	8,279	8,926	9,962
Selling and administrative	6,518	7,136	7,314
Research and development	1,142	1,143	1,233
Depreciation and amortization	739	800	1,097
Impairment of goodwill and fixed assets	—	9,298	—
<b>Total costs and expenses</b>	<b>16,678</b>	<b>27,303</b>	<b>19,606</b>
Operating income (loss)	1,654	(8,083)	876
OTHER INCOME:			
Interest	97	113	258
Patent and other settlements	—	691	—
<b>Total other income</b>	<b>97</b>	<b>804</b>	<b>258</b>
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	1,751	(7,279)	1,134
PROVISION FOR INCOME TAXES	744	858	543
NET INCOME (LOSS)	\$ 1,007	\$ (8,137)	\$ 591
NET INCOME (LOSS) PER SHARE:			
Basic and diluted	\$ 0.05	\$ (0.44)	\$ 0.03

The accompanying notes are an integral part of these financial statements.

## Statements of Stockholders' Equity

(In Thousands)	Common Stock		Additional Paid-In Capital	Retained (Deficit) Earnings	Total
	Shares	Amount			
BALANCE, JANUARY 1, 2001	18,484	\$ 185	\$ 23,994	\$ (191)	\$ 23,988
Net income	—	—	—	591	591
BALANCE, DECEMBER 31, 2001	18,484	185	23,994	400	24,579
Net loss	—	—	—	(8,137)	(8,137)
BALANCE, DECEMBER 31, 2002	18,484	185	23,994	(7,737)	16,442
Net income	—	—	—	1,007	1,007
BALANCE, DECEMBER 31, 2003	18,484	\$ 185	\$ 23,994	\$ (6,730)	\$ 17,449

The accompanying notes are an integral part of these financial statements.

# Statements of Cash Flows

<i>(In Thousands)</i>	<i>YEARS ENDED DECEMBER 31,</i>		
	2003	2002	2001
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 1,007	\$ (8,137)	\$ 591
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	739	800	1,097
Deferred income taxes	744	858	543
(Recovery) provision for doubtful accounts	(30)	160	17
Impairment of goodwill and fixed assets	—	9,298	—
Changes in operating assets and liabilities:			
Accounts receivable	517	(771)	(500)
Inventories	155	726	(252)
Prepaid expenses and other	486	(140)	(171)
Accounts payable and accrued expenses	(455)	(1,138)	(1,078)
Customer advances	(40)	(11)	(61)
<b>Net cash provided by operating activities</b>	<b>3,123</b>	<b>1,645</b>	<b>186</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Capital expenditures	(441)	(354)	(744)
<b>Net cash used in investing activities</b>	<b>(441)</b>	<b>(354)</b>	<b>(744)</b>
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>2,682</b>	<b>1,291</b>	<b>(558)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	<b>8,659</b>	<b>7,368</b>	<b>7,926</b>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>\$ 11,341</b>	<b>\$ 8,659</b>	<b>\$ 7,368</b>
<b>SUPPLEMENTAL CASH PAYMENTS:</b>			
Taxes	\$ 5	\$ 2	\$ 5
Interest	\$ —	\$ —	\$ —

*The accompanying notes are an integral part of these financial statements.*

## 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

American Bank Note Holographics, Inc. (the “Company” or “ABNH”) was incorporated in the state of Delaware in August 1985. The Company was, until July 20, 1998 (the “Offering Date”), a wholly-owned subsidiary of American Banknote Corporation (the “Former Parent” or “ABN”).

The Company originates, mass-produces, and markets secure holograms. Holograms are used for security, packaging and promotional applications. The Company operates in one reportable industry segment.

**Use of Estimates** — The preparation of financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of sales and expenses during the reporting period. Actual results may differ materially from those estimates.

**Cash and Cash Equivalents** — All highly liquid investments (primarily government bonds) with a maturity of three months or less, when purchased, are considered to be cash equivalents and are stated at cost, which approximates market.

**Concentrations of Credit Risk** — A significant portion of the Company’s accounts receivable are due from credit card issuers and related credit card manufacturers located throughout the United States and Europe. At December 31, 2003 and for the year then ended, one customer accounted for 30% of the Company’s accounts receivable and 33% of its sales, and a second customer accounted for 30% of the Company’s accounts receivable and 9% of its sales. At December 31, 2002 and for the year then ended, one customer accounted for 40% of the Company’s accounts receivable and 41% of its sales, and a second customer accounted for 24% of the Company’s accounts receivable and 11% of its sales. The Company establishes its credit policies based on an ongoing evaluation of its customers’ creditworthiness and competitive market conditions and does not require collateral.

**Inventories** — Inventories are stated at the lower of cost or market with cost being determined on the first-in, first-out (FIFO) method. The cost of hologram originations (which represent costs of a unique master hologram that is made to customer specifications and is an integral part of the production process) are charged to cost of goods sold in the period incurred.

**Revenue Recognition** — The Company recognizes revenue in accordance with the provisions of the Securities and Exchange Commission’s (“SEC”) Staff Accounting Bulletin (“SAB”) No. 101, “Revenue Recognition.” Specifically, sales and the related cost of goods sold are generally recognized at the latter of the time of shipment or when title passes to customers. In some situations, the Company has shipped product where the sale is contingent upon the customers’ use of the product. In these situations, the Company does not recognize sales upon product shipment, but rather when the buyer of the product informs the Company that the product has been used. Additionally, pursuant to terms with a certain customer, completed items are stored on behalf of the customer at the Company’s on-site secured facility and, in that

instance, sales are recognized when all of the following have occurred: the customer has ordered the goods, the manufacturing process is complete, the goods have been transferred to the on-site secured facility and are ready for shipment, the risk of ownership has passed to the customer and the customer has been billed for the order. At December 31, 2003 and 2002, accounts receivable from this customer approximated \$1.0 million and \$1.6 million, respectively.

At both December 31, 2003 and 2002, customer advances approximating \$0.1 million represent payments received from customers for products which have not yet been shipped. These customer advances are classified as current liabilities on the accompanying balance sheets.

Effective October 1, 2000, the Company adopted the Emerging Issues Task Force, (“EITF”) 00-10, “Accounting for Shipping and Handling Fees and Costs.” Under the provisions of EITF 00-10, shipping and handling amounts billed to customers are included in revenues and shipping and handling costs are included in selling and administrative expenses and amounted to \$358,000, \$373,000, and \$370,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

**Royalty Income** — The Company enters into licensing agreements with certain manufacturers under which the Company receives royalty payments. Royalty payments due under licensing agreements are recognized as income either based upon shipment reports from licensees, where available, or estimated shipments by such licensees.

**Depreciation and Amortization** — Machinery and equipment are recorded at cost and are depreciated using the straight-line method over the estimated useful lives ranging from 5 to 15 years.

Amortization of leasehold improvements is computed using the straight-line method based upon the remaining term of the applicable lease, or the estimated useful life of the asset, whichever is shorter.

**Long-Lived Assets** — In July 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 143, “Accounting for Asset Retirement Obligations,” which requires obligations associated with the retirement of long-lived assets to be recorded as increases in costs of the related asset. Also, on October 3, 2001, the FASB issued SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS No. 144 supercedes SFAS No. 121, “Accounting for the Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.” SFAS No. 144 develops one accounting model for determining impairment based on the model in SFAS No. 121, and for long-lived assets that are to be disposed of by sale, requires them to be recorded at the lower of book value or fair value less cost to sell. In addition, SFAS No. 144 expands the scope of “discontinued operations.” The new rules were applied prospectively beginning January 1, 2002.

During the quarter ended December 31, 2002, the Company recorded a charge for the impairment of long-lived assets of \$1.9 million to write off fixed assets consisting of master plates which will no longer be used. The impairment charge, which was recorded under the requirements of SFAS No. 144, represents the full impairment of this long-lived asset on our balance sheet. This asset arose through purchase accounting by the Company’s Former Parent, as it related to the Company, in connection with the Former Parent’s merger in 1990. There was no impairment of long-lived assets in 2003.

**Goodwill** — In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which provides that goodwill should not be amortized but instead tested for impairment on an annual basis, was adopted by the Company on January 1, 2002. The impairment testing is performed in two steps: (i) the determination of impairment, based on the fair value of the Company compared with its carrying value, and (ii) if there is an indication of impairment, this step measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. In accordance with SFAS No. 142 the Company completed the transitional impairment test during the quarter ended March 31, 2002, which testing indicated that no adjustment was required upon the adoption of the pronouncement. The Company performed the annual test for impairment required by SFAS No. 142 during the quarter ended December 31, 2002. At that time the fair value (based on quoted market prices) of the Company was found to be less than its carrying amount and as a result, the Company recorded a \$7.4 million impairment charge for the year ended December 31, 2002. This charge represents the full impairment of the goodwill on the Company's balance sheet. This asset arose through purchase accounting by the Company's Former Parent, as it related to the Company, in connection with the Former Parent's merger in 1990.

As a result of the adoption of SFAS No. 142, the amortization of goodwill ceased as of January 1, 2002. Had goodwill amortization been recorded in 2002, goodwill amortization expense of \$345,000 would have been included in the accompanying statement of operations for the year ended December 31, 2002.

The 2001 historical financial statements do not reflect the provisions of SFAS No. 142. Had the Company adopted SFAS No. 142 on January 1, 2001, net income and basic and diluted net income per share for the year ended December 31, 2001, would have been as follows (in thousands, except per share data):

	2001
Net income as reported	\$ 591
Add: Goodwill amortization	345
Adjusted net income	\$ 936
Pro forma basic and diluted net income per share	\$ 0.05

**Warranty Costs** — The Company provides for warranty costs in amounts it estimates will be needed to cover future warranty obligations for products sold during the year. Estimates of warranty costs are based on historical experience and are periodically reviewed and adjusted, when necessary. The Company's product warranty provision is included in accrued expenses in the accompanying balance sheets. Changes in the Company's warranty provision during the years ended December 31, 2003, 2002 and 2001 are as follows (in thousands):

	2003	2002	2001
Balance at beginning of year	\$ 605	\$ 1,011	\$ 935
Warranties provided	160	410	260
Settlements made	(255)	(816)	(184)
Balance at end of year	\$ 510	\$ 605	\$ 1,011

**Research and Development** — Research and development costs are expensed as incurred.

**Income Taxes** — The Company accounts for income taxes under the liability method in accordance with SFAS No. 109, "Accounting for Income Taxes." The provision for income taxes includes deferred income taxes resulting from items reported in different periods for income tax

represent the expected future tax consequences of the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis.

**Stock-Based Compensation Plans** — In December 2002, FASB issued SFAS No. 148, "Accounting for Stock Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation from the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation." The Company adopted the disclosure requirements of SFAS No. 148 effective December 31, 2002. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value-based method of accounting prescribed in APB Opinion No. 25, and accordingly, does not recognize compensation expense for stock option grants made at an exercise price equal to or in excess of the fair market value of the stock at the date of grant.

Had compensation cost for the Company's outstanding stock options been determined based on the fair value at the grant dates for those options consistent with SFAS No. 123, the Company's 2003, 2002 and 2001 net income (loss) and basic and diluted net income (loss) per share would have differed as reflected by the pro forma amounts indicated below (in thousands, except per share data):

<i>(In Thousands, Except Per Share Data)</i>	2003	2002	2001
Net income (loss), as reported	\$ 1,007	\$ (8,137)	\$ 591
Add: Non-cash employee compensation, as reported	—	—	—
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of taxes	47	199	411
Pro forma, net income (loss)	\$ 960	\$ (8,336)	\$ 180
Basic and diluted net income (loss) per share, as reported	\$ 0.05	\$ (0.44)	\$ 0.03
Basic and diluted net income (loss) per share, pro forma	\$ 0.05	\$ (0.45)	\$ 0.01

**Basic and Diluted Net Income (Loss) per Share** — Basic net income (loss) per share is computed based on the weighted average number of outstanding shares of common stock. The basic weighted average number of shares outstanding were 18,483,720 for each of the years ended December 31, 2003, 2002 and 2001. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding and dilutive potential shares of common stock. For the year ended December 31, 2003, the diluted number of weighted shares outstanding was 18,525,914, which includes dilutive stock options of 42,194. For each of the years ended December 31, 2002 and 2001, the diluted weighted average number of shares outstanding were 18,483,720. For the years ended December 31, 2002 and 2001, the effect of options to purchase 2,318,500 shares and 2,509,500 shares, respectively, of the Company's common stock were excluded from the calculation of diluted net income (loss) per share because the effect of inclusion of such options would have been antidilutive. For the years ended December 31, 2002 and 2001, the effect of

warrants to purchase 863,647 shares and 215,912 shares, respectively, of the Company's common stock were excluded from the calculation of diluted net income (loss) per share because the effect of inclusion of such warrants would have been antidilutive. The warrants expired on June 18, 2003.

**Business Concentration Risks** — Sales to MasterCard were approximately 33%, 41% and 37% of sales for the years ended December 31, 2003, 2002 and 2001, respectively. At December 31, 2003 and 2002, accounts receivable from MasterCard approximated \$1.0 million and \$1.6 million, respectively. The Company entered into an agreement with MasterCard dated February 28, 2003, which replaced the agreement dated February 1, 1996, as amended. The Company and MasterCard entered into an amendment to this agreement on September 29, 2003, in which MasterCard retained the Company to produce a new hologram for the Debit MasterCard and extended the agreement to February 28, 2011, subject to automatic renewal if not terminated by either party. The agreement also provides that MasterCard will receive three sequential price reductions of approximately 3% each, effective at the beginning of 2003, 2004 and 2006. The Company is currently the exclusive supplier to MasterCard. The loss of all or a substantial portion of the sales to MasterCard, however, would have a material adverse effect on the financial position, results of operations and cash flows of the Company.

Sales to manufacturers of VISA credit cards (approximately 50 customers) were approximately 30%, 26% and 23% of sales for the years ended December 31, 2003, 2002 and 2001, respectively. The loss of a substantial portion of the sales to these customers would have a material adverse effect on the financial position, results of operations and cash flows of the Company. At December 31, 2003 and 2002, accounts receivable from these customers approximated \$1.3 million and \$1.5 million, respectively.

The Company has historically purchased certain key materials used in the manufacture of its holograms from single suppliers, with which it does not have supply contracts. Any problems that occur with respect to the delivery, quality or cost of any such materials could have a material adverse effect on the financial position, results of operations and cash flows of the Company.

**Export Sales** — Export sales were 28%, 27% and 28% of sales for the years ended December 31, 2003, 2002 and 2001, respectively. All export sales are denominated in United States dollars. At each of December 31, 2003 and 2002, accounts receivable from these customers approximated \$0.5 million.

**Comprehensive Income** — In 1998, the Company adopted SFAS No. 130, "Reporting Comprehensive Income," which establishes rules for the reporting of comprehensive income and its components. For each of the years ended December 31, 2003, 2002, and 2001, there was no difference between the Company's net income (loss) and comprehensive income (loss).

**Fair Value of Financial Instruments** — The Company's financial instruments consist of cash and cash equivalents, accounts receivables, accounts payable and accrued expenses. The carrying amounts reported in the balance sheets approximate their fair value at both December 31, 2003 and 2002.

## 2. INVENTORIES

	December 31,	
(In Thousands)	2003	2002
Finished goods	\$ 800	\$ 1,226
Finished goods on consignment with customers	417	377
Work in process	764	455
Raw materials	405	483
Inventories	\$ 2,386	\$ 2,541

## 3. MACHINERY, EQUIPMENT AND LEASEHOLD IMPROVEMENTS

	December 31,	
(In Thousands)	2003	2002
Machinery and equipment	\$ 10,583	\$ 10,205
Leasehold improvements	1,145	1,082
	11,728	11,287
Accumulated depreciation and amortization	9,238	8,505
Machinery, equipment and leasehold improvements, net	\$ 2,490	\$ 2,782

Depreciation and amortization of machinery and equipment and leasehold improvements for the years ended December 31, 2003, 2002 and 2001 were \$733,000, \$794,000 and \$749,000, respectively.

During the quarter ended December 31, 2002, the Company recorded an asset impairment charge of \$1.9 million to write off fixed assets consisting of master plates which will no longer be used (see Note 1).

## 4. ACCRUED EXPENSES

	December 31,	
(In Thousands)	2003	2002
Accrued contract liability	\$ 357	\$ 357
Warranty reserves	510	605
Federal, state and local income taxes	61	66
Salaries and wages	527	520
Accrued professional fees	63	107
Other	109	148
	\$ 1,627	\$ 1,803

## 5. INCOME TAXES

In accordance with a tax allocation agreement in effect through the Offering Date, the Company was included in the consolidated U.S. Federal income tax return and, in certain instances, consolidated or combined state and local income tax returns of its Former Parent and made payments to the Former Parent based on the amounts which would be payable as Federal, state and local income taxes as if consolidated or combined returns were not filed. The Company computed its Federal, state and local income tax provision as if it was filing separate income tax returns, without regard to the tax allocation agreement. During 2000, the Company and the Former Parent reached an agreement, which provides, among other things that the Former Parent will be responsible for and shall pay all asserted and unasserted income, franchise and similar tax liabilities of the Company for the period

January 1, 1990 through July 20, 1998 and will indemnify the Company with respect to any such liabilities. For periods subsequent to the Offering Date, the Company is filing its own U.S. Federal and state income tax returns.

Deferred income taxes arise from temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements.

Provision for income taxes are as follows:

(In Thousands)	For the Years Ended December 31,		
	2003	2002	2001
Current:			
Federal	\$ —	\$ —	\$ —
State and local	—	—	—
Deferred:			
Federal	573	655	423
State and local	171	203	120
	744	858	543
	\$ 744	\$ 858	\$ 543

A reconciliation of the taxes on income in 2003, 2002 and 2001 is as follows:

(In Thousands)	For the Years Ended December 31,		
	2003	2002	2001
Tax at statutory rate	\$ 613	\$ (2,475)	\$ 397
Amortization and impairment of nondeductible goodwill and long-lived assets	—	3,161	122
State and local taxes, net of Federal benefit	111	133	89
Other	20	39	(65)
	\$ 744	\$ 858	\$ 543

The tax effects of the items comprising the Company's deferred income tax assets and liabilities are as follows:

(In Thousands)	December 31,	
	2003	2002
Current deferred tax assets:		
Uniform capitalization of inventory	\$ 230	\$ 228
Bad debt reserve	76	89
Warranty reserve	214	254
Inventory obsolescence	173	492
Accrued vacation	83	79
Other liabilities	205	205
Net current deferred tax asset	\$ 981	\$ 1,347
Non current deferred tax asset:		
Net operating loss carryforward	\$ 108	\$ 574
	108	574
Non current deferred tax liabilities:		
Excess tax over book depreciation	(1,316)	(1,404)
Net non current deferred tax liability	\$ (1,208)	\$ (830)

At December 31, 2003, the Company has net operating loss carryforwards of approximately \$0.3 million, which expire through 2022, available to offset future Federal taxable income. For the year ended December 31, 2003, the Company used net operating loss carryforwards of approximately \$1.1 million to offset current Federal income taxes. Current or future changes in ownership could limit the availability to use these net operating loss carryforwards.

## 6. STOCKHOLDERS' EQUITY

On June 11, 1998, the Company increased its authorized common stock to 30,000,000 shares and its authorized preferred stock to 5,000,000 shares. On July 20, 1998, the Former Parent completed the sale of 13,636,000 shares of the Company's common stock in a public offering (the "Offering"), representing its entire investment in the Company. During 2001 and 2002 the Company issued and distributed 1,460,000 shares of its common stock as well as warrants to purchase 863,647 shares of the Company's common stock, at an exercise price of \$6.00 per share in settlement of the class action lawsuit filed against the Company in 1999. The warrants expired on June 18, 2003. None of the warrants were exercised. On August 10, 2001, the Company's stockholders approved an amendment to the Company's Amended and Restated Articles of Incorporation increasing the number of authorized shares of its common stock to 40,000,000 shares.

On June 30, 2000, the Company entered into a Stock Purchase Agreement (the "Agreement") with Crane & Co., Inc. ("Crane"). Under the Agreement, the Company sold 3,387,720 shares of the Company's common stock to Crane for an aggregate purchase price of \$9,316,230. The Agreement also provides that the Board of Directors of the Company and the audit committee of the Board of Directors each be expanded by one position, which was filled by Douglas A. Crane, a representative of Crane.

The Agreement also contains a standstill provision, whereby Crane agreed, that, among other things, neither it nor its affiliates, except as otherwise provided for in the Agreement, will acquire more than its current proportionate share of the outstanding securities of the Company. The standstill provision also provides that Crane will not offer, sell or transfer any of its voting securities of the Company during a tender or exchange offer if such offer is opposed by the Company's Board of Directors.

During 2000, the Company entered into additional agreements with Crane under which the Company rents factory space and leases employees for the Company's facility in Dalton, MA. For the years ended December 31, 2003, 2002 and 2001, the Company paid Crane under these agreements, \$72,000 each year, for the rental of factory space and \$162,000, \$151,000 and \$116,000, respectively, for the leased employees, which are primarily included in cost of goods sold in the accompanying statements of operations. In addition, the Company paid Crane \$5,700 for leasehold improvements on the rental space for the year ended December 31, 2001. On February 28, 2003, the Company entered into a new agreement with MasterCard which entitles MasterCard to appoint Crane as its second supplier to produce up to 20% of MasterCard's annual hologram requirements in coordination with the Company. In addition, the agreement allows MasterCard to appoint Crane as its contingent supplier under certain circumstances.

## 7. SETTLEMENT AGREEMENT

ABNH and Leonhard Kurz GmbH & Co. KG ("Kurz") entered into a Settlement Agreement dated as of July 1, 2002. Pursuant to the Settlement Agreement, Kurz will make payments to ABNH totaling \$900,000 over two years, with \$300,000 paid upon settlement and the remainder payable in eight quarterly installments of \$75,000 beginning in October 2002 in exchange for a release from any past, present and future infringements of ABNH's demetallizing and hot-stamping patents except for a future use of a specific interpretation of the demetallizing patents which is subject to a royalty based license. ABNH recorded such amounts as other income in the accompanying statement of operations in 2002, net of legal expenses of \$280,000 and imputed interest of \$50,000.

## 8. STOCK INCENTIVE PLANS

On August 4, 2000, the Company adopted the American Bank Note Holographics, Inc. 2000 Stock Incentive Plan (as amended, the "2000 Plan"), which was subsequently approved by the Company's stockholders at the annual meeting on September 12, 2000. On July 20, 1998, the Company adopted the 1998 Stock Incentive Plan (as amended, the "1998 Plan", and collectively with the 2000 Plan, the "Plans"). The

Plans were adopted for the purpose of granting various stock incentives to officers, directors, employees and consultants of the Company. The Board of Directors (or a committee appointed by the Board of Directors) has discretionary authority, subject to certain restrictions, to administer the Plans. The total number of shares reserved for issuance under the Plans are 3,213,000 shares of common stock. Options to purchase 390,000 shares of common stock are available for future grants at December 31, 2003 under the Plans. Options to purchase 2,823,000 shares of common stock were outstanding under the Plans at December 31, 2003. Options to purchase an additional 15,000 shares of common stock were outstanding outside the Plans at December 31, 2003. The exercise price of options granted under the Plans may not be less than 100% of the fair market value of the common stock on the date such option was granted. Options granted under the Plans generally become vested and exercisable for up to 25% or 33 1/3% of the total optioned shares upon each succeeding anniversary of the date of grant. Generally, the unexercised portion of any option automatically terminates upon the termination of the optionee's employment with the Company, unless otherwise determined by the Board of Directors; provided however, that any extension shall not extend beyond the expiration of the option, generally ten years. Upon a change in control, outstanding options will generally become fully vested.

A summary of the status of the Company's outstanding stock options as of December 31, 2003, 2002 and 2001 and changes during the years then ended follows:

	2003		2002		2001	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	2,318,500	\$ 2.55	2,509,500	\$ 2.58	2,472,500	\$ 2.64
Granted	586,000	0.91	23,000	1.02	188,000	1.83
Forfeited	(66,500)	3.61	(214,000)	2.76	(151,000)	2.69
Outstanding, end of year	2,838,000	2.19	2,318,500	2.55	2,509,500	2.58
Exercisable, end of year	2,170,251	2.54	1,944,124	2.67	1,524,069	2.91
Weighted average fair value of options granted during the year	\$ 0.78		\$ 0.84		\$ 1.52	

The following table summarizes information concerning outstanding and exercisable options at December 31, 2003:

Options Outstanding			Options Exercisable		
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
\$0.68 - \$1.18	607,000	9.54	\$0.95	9,334	\$1.03
\$1.67 - \$1.9375	855,000	6.53	\$1.86	817,417	\$1.86
\$2.03125 - \$2.50	1,233,833	5.83	\$2.31	1,201,333	\$2.31
\$8.50	142,167	4.55	\$8.50	142,167	\$8.50
\$0.68 - \$8.50	2,838,000	6.77	\$2.19	2,170,251	\$2.54

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	2003	2002	2001
Expected volatility	62.30%	63.10%	76.84%
Risk-free interest rate	3.15% to 4.25%	3.63% to 4.02%	4.97% to 5.52%
Dividend yield	—	—	—
Expected life	7.5 years	7.5 years	7.5 years

## 9. EMPLOYEE BENEFITS PLANS

**Retirement Plans** — On October 1, 1999, the Company implemented defined contribution plans for its employees. Aggregate contributions to such plans, which have been charged to the Company's operations, were approximately \$56,000, \$51,000 and \$48,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

## 10. COMMITMENTS AND CONTINGENCIES

During 1991 ABNH entered into a Patent License Agreement (the "License Agreement"), which required ABNH to pay royalties in connection with certain products that ABNH produces. During 2002, the licensor under the License Agreement filed a lawsuit against ABNH in the United States District Court for the Eastern District of Washington, alleging breach of the License Agreement. In December 2002, ABNH entered into a settlement agreement whereby ABNH paid \$431,250 on December 31, 2002. The payment satisfied all obligations by ABNH to pay royalties that may have been owed both for the past and the future under the License Agreement. ABNH recorded \$231,250 as royalty expense in 2002, in the accompanying statements of operations to cover allegedly past due royalties and \$200,000 is being amortized over the remaining life of the patents, which expire in 2005 and 2007.

The Company currently, and from time-to-time, is involved in litigation (as both plaintiff and defendant) incidental to the conduct of its business; however, the Company is not a party to any lawsuit or proceeding which, in the opinion of management of the Company, is likely to have a material impact on the Company's financial position, results of operations or cash flows.

Amounts accrued for litigation matters represent the anticipated costs (damages and/or settlement amounts) in connection with pending litigation and claims. The costs are accrued when it is both probable that an asset has been impaired or a liability has been incurred and the amount can be reasonably estimated. The accruals are based upon the Company's assessment, after consultation with counsel, of probable loss based on the facts and circumstances of each case, the legal issues involved, the nature of the claim made, the nature of the damages sought and any relevant information about the plaintiffs, and other significant factors which vary

by case. When it is not possible to estimate a specific expected cost to be incurred, the Company evaluates the range of probable loss and records the minimum end of the range. As of December 31, 2003 and 2002, accruals for litigation matters approximated \$15,000 and \$10,000, respectively. The Company believes, based on information known at December 31, 2003, that anticipated probable costs of litigation matters as of December 31, 2003 have been adequately provided to the extent determinable.

**Indemnification from Former Parent** — As described in Note 5, during 2000, the Company and its Former Parent entered into an agreement, which, among other matters, provide for the indemnification, under certain circumstances, of the Company by the Former Parent. The Former Parent has experienced significant financial difficulty, which may result in its inability to perform under the terms of the indemnification provided, which could have a material adverse effect on the Company's financial position, results of operations and cash flows.

**Product Liability Matters** — The Company provides holograms in connection with a wide range of its customers' products, in which case it is possible that the Company is subject to product liabilities in association with those products or in connection with the holograms used with those products. Although the Company maintains product liability insurance, there can be no assurance that such insurance would be available to cover any such claim or available in amounts sufficient to cover all potential liabilities. As a result, product liability claims could have a material adverse effect on the Company's business, financial condition, results of operations and cash flows.

**Leases** — The Company has long-term operating leases for offices, manufacturing facilities and equipment, which expire through 2007. The Company has renewal options on some locations, which provide for renewal rents based upon increases tied to the consumer price index.

Rental expense was approximately \$1.3 million each year for the years ended December 31, 2003, 2002 and 2001, respectively.

At December 31, 2003, future minimum lease payments under non-cancelable operating leases, expiring through 2007, are as follows: \$1.0 million in 2004; \$0.9 million in 2005; \$0.9 million in 2006; and \$0.8 million in 2007.

**Employment Agreements** — The Company entered into employment agreements with certain of its current officers, which provide for, among other matters, minimum compensation of approximately \$421,000 in 2004 and \$328,000 in 2005. The agreements also provide for bonuses. In connection with these agreements, the Company granted options to acquire 1,553,000 shares of its common stock from February 1999 through December 2003, at prices ranging from \$0.85 to \$2.50 per share, representing the fair market value of the Company's common stock on the dates of grants.

# Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock has been quoted on the NASD's Over-the-Counter Bulletin Board quotation service under the symbol "ABHH," since March 31, 2000. Our securities are not listed or quoted on any exchange or other quotation system.

The following table sets forth the high and low closing prices of our common stock for each quarter of 2002, 2003 and the first five months of 2004.

	High	Low
<b>2002</b>		
First Quarter	\$ 1.92	\$ 1.39
Second Quarter	2.08	1.14
Third Quarter	1.39	0.85
Fourth Quarter	0.93	0.63
<b>2003</b>		
First Quarter	\$ 0.98	\$ 0.71
Second Quarter	1.22	0.79
Third Quarter	1.29	1.05
Fourth Quarter	1.53	1.08
<b>2004</b>		
First Quarter	\$ 2.40	\$ 1.50
Second Quarter (through May 28, 2004)	2.87	1.88

Warrants to purchase our common stock were quoted on the NASD's Over-the-Counter Bulletin Board quotation service from August 27, 2002 to June 18, 2003, the date the warrants expired. During 2002, the warrants had high and low closing prices of \$0.05 and \$0.01, respectively, during the third quarter and a high and low closing price of \$0.01 during the fourth quarter. During 2003, the warrants had high and low closing prices of \$0.03 and \$0.01, respectively, during the first quarter and high and low closing prices of \$0.01 and \$0.001, respectively, during the period ended June 18, 2003.

As of June 9, 2004, there were approximately 534 holders of record of our common stock. Because many of our shares of common stock are held of record by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of beneficial stockholders represented by these record holders.

We have not paid cash dividends during the past two fiscal years. We have no plans or intentions of paying dividends in the foreseeable future.

# Unaudited Quarterly Results of Operations for the Years Ended December 31, 2003 and 2002

<i>(In Thousands, Except Per Share Data)</i>	<i>YEAR ENDED DECEMBER 31, 2003</i>			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Sales	\$ 4,538	\$ 4,275	\$ 4,629	\$ 4,842
Cost of goods sold	2,016	1,988	2,090	2,185
Net income	219	120	298	370
Net income per share-basic and diluted	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.02

<i>(In Thousands, Except Per Share Data)</i>	<i>YEAR ENDED DECEMBER 31, 2002</i>			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Sales	\$ 4,620	\$ 4,836	\$ 4,712	\$ 4,497
Cost of goods sold	2,314	2,506	2,032	2,074
Net income (loss)	67	134	694	(9,032)
Net income (loss) per share-basic and diluted	\$ 0.00	\$ 0.01	\$ 0.04	\$ (0.49)

## Quantitative and Qualitative Disclosures About Market Risk

We do not engage in significant activity with respect to market risk sensitive instruments. Accordingly, our risk with respect to market risk sensitive instruments is immaterial.

# Report of Independent Auditors

To the Board of Directors and Stockholders of  
American Bank Note Holographics, Inc.

We have audited the accompanying balance sheets of American Bank Note Holographics, Inc. (the "Company") as of December 31, 2003 and 2002 and the related statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of the Company as of December 31, 2001 and for the year then ended were audited by other auditors who have ceased operations and whose report dated March 1, 2002, expressed an unqualified opinion on those statements:

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 2003 and 2002 financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2003 and 2002 and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States.

As discussed above, the financial statements of the Company as of December 31, 2001 and for the year then ended, were audited by other auditors who have ceased operations. As described in Note 1, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards ("Statement") No. 142, "Goodwill and Other Intangible Assets," which was adopted by the Company as of January 1, 2002. Our audit procedures with respect to the disclosures in Note 1 with respect to 2001 included (a) agreeing the previously reported net income to the previously issued financial statements and the adjustments to reported net income representing amortization expense recognized in that period related to goodwill that are no longer being amortized as a result of initially applying Statement No. 142 to the Company's underlying records obtained from management, and (b) testing the mathematical accuracy of the reconciliation of adjusted net income to reported net income, and the related net income per share amounts. In our opinion, the disclosures for 2001 in Note 1 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2001 financial statements of the Company other than with respect to such disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 2001 financial statements taken as a whole.



Ernst & Young LLP  
New York, New York  
March 5, 2004

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## Report of Independent Public Accountants

The following is a copy of the previously issued report of Arthur Andersen LLP dated March 1, 2002, related to their audit of the financial statements of American Bank Note Holographics, Inc., as of and for the two-year period ended December 31, 2001. During 2002, Arthur Andersen LLP ceased operations and, as such, has not reissued this report. Additionally, Arthur Andersen LLP has not consented to the use of this audit report. Since American Bank Note Holographics, Inc. is unable to obtain a current manually signed audit report, a copy of Arthur Andersen's most recent signed and dated report has been included to satisfy filing requirements, as permitted under Rule 2-02(e) of Regulation S-X.

To the Board of Directors and Stockholders of  
American Bank Note Holographics, Inc.:

We have audited the accompanying balance sheets of American Bank Note Holographics, Inc. (a Delaware corporation) as of December 31, 2001 and 2000 and the related statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements and schedule referred to below are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of American Bank Note Holographics, Inc. as of December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedule on page S-1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



Arthur Andersen LLP  
New York, New York  
March 1, 2002

# Corporate Information

## EXECUTIVE OFFICERS

**Kenneth H. Traub**  
*President and  
Chief Executive Officer*

**Salvatore F. D'Amato**  
*Chairman of the Board*

**Alan Goldstein**  
*Vice President and  
Chief Financial Officer*

## BOARD OF DIRECTORS

**Kenneth H. Traub**  
*President and  
Chief Executive Officer  
American Bank Note Holographics, Inc.*

**Salvatore F. D'Amato**  
*Chairman of the Board  
American Bank Note Holographics, Inc.*

**Fred J. Levin**  
*President and  
Chief Executive Officer  
LGI Network LLC*

**Douglas A. Crane**  
*Manager of Currency Paper Manufacturing  
and  
U.S. Currency Contract  
Crane & Co., Inc.*

**Mark J. Bonney**  
*Managing Partner  
Endeavour Advisors, LLC*

## COUNSEL

**Fulbright & Jaworski L.L.P.**  
*666 Fifth Avenue  
New York, NY 10103*

## INDEPENDENT AUDITORS

**Ernst & Young LLP**  
*5 Times Square  
New York, NY 10036*

**Annual Meeting of Stockholders**  
*August 3, 2004 at 10:00am  
Westchester Marriott Hotel  
670 White Plains Road  
Tarrytown, NY 10591*

## Form 10-K

*ABNH has filed an Annual Report on Form 10-K with the Securities and Exchange Commission. Copies of this report can be obtained free of charge by calling or writing to the ABNH headquarters at the phone number or address set forth below, attention, Investor Relations.*

## TRANSFER AGENT AND REGISTRAR

**American Stock Transfer & Trust Co.**  
*6201 15th Avenue – Third Floor  
Brooklyn, NY 11219*

**Internet Address**  
*[www.abnh.com](http://www.abnh.com)*

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